Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:OHI:CLE:TL-N-7905-98
CAFisher

date: June 4, 1999

to: Chief, Examination Division, Ohio District
Charles Britten, Team Coordinator - Independence, Ohio
Jeffrey A. Myers, Engineer/Revenue Agent - Columbus, Ohio

from: Associate District Counsel, Ohio District
Cleveland, Ohio

subject: [redacted]/**Reserve Account Issue**
U.I.L. No. 451.19-00

This responds to your request for advice regarding the [redacted]/Reserve Account issue. Our advice is provided without prior coordination with the Office of Chief Counsel, pursuant to the 10-Day Post Review procedures of CCDM (35)3(19)4(4), as this issue involves primarily well-settled principles of law. We are required, however, to forward a copy of this memorandum to both the Assistant Chief Counsel (Field Service) and the Northeast Regional Office for review. Within 10 days after receipt, the Associate Chief Counsel is to advise this office as to whether it: 1) concurs with our opinion; 2) believes some modification is appropriate; or 3) needs additional information or time to evaluate our opinion. We will inform you of their response as soon as it is received.

Disclosure Statement

This document may contain confidential information subject to the attorney-client and deliberative process privileges, and may also have been prepared in anticipation of litigation. This document should not be disclosed to anyone outside the Service, including taxpayer(s) involved, and its use within the Service should be limited to those with a need to review the document in relation to the subject matter or case discussed herein. This document is also tax information of the instant taxpayer which is subject to section 6103 of the Internal Revenue Code[1].

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[1] All section references hereinafter, unless otherwise indicated, are to the Internal Revenue Code as in effect during the years in issue.

Issue

Whether [redacted] must recognize as income in [redacted], that portion of the proceeds from the sale of certain student loans to the [redacted] which it deposited into the Reserve Account.

Conclusion

We conclude that the portion of the proceeds received by [redacted] and deposited into the Reserve Account should be included in its [redacted] taxable income. [redacted]'s deposit will be either returned to it or applied to pay expenses for which the Reserve Account was established. We find that either way, [redacted] is benefitted by the deposit and, as such, no real contingency existed in [redacted] as to whether [redacted] had a "fixed right to receive" that portion of the sales proceeds deposited to the Reserve Account.

Facts

The [redacted] was established under the laws of the state of New York on [redacted][2], by [redacted]. [redacted] was selected as the Eligible Lender Trustee ("Trustee") for the Trust. The Trustee and [redacted] agreed that on or before [redacted], the Trust would purchase certain [redacted] student loans from [redacted] with an aggregate principal balance of approximately $[redacted] as of [redacted].[4] Initial capitalization of the Trust for the purchase was obtained from the sale of equity interests in the Trust totaling $[redacted]. These equity interests were designated as the Floating Rate Asset Backed Certificates ("Certificates"). Certificates totaling approximately $[redacted] were sold to [redacted], and the remaining Certificates were sold to unrelated third-party investors. Monthly income distributions to the Certificate Holders were to be paid at LIBOR plus [redacted]% of the Certificate Holder's principal amount.

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[2] The information concerning the Trust set forth herein was obtained from the Trust Prospectus dated [redacted].

[3] [redacted] and [redacted] merged effective [redacted]. [redacted] thereafter became a subsidiary of [redacted].

[4] The loans were guaranteed by non-profit entities, and some of which were also reinsured by the federal government.

In addition to the Certificates, the Trust was authorized to raise additional capital of $[redacted] through the sale of securities known as Floating Rate Asset Backed Notes ("Notes"). The Notes represent obligations of the Trust, and were generally to pay monthly interest at LIBOR plus [redacted]% (unless the interest rate exceeds the interest rate due to the Trust on the underlying student loans, in which case the interest rate due the Note Holders will be limited to the student loan rate). Principal is repaid quarterly. The interests of the Certificate Holders are subordinated to the payments of principal and interest to the Note Holders.

Under the terms of the Sales and Servicing Agreement[5], [redacted] agreed to deposit $[redacted] of the net proceeds that it received from the sale of the student loans into the Reserve Account ("Reserve Account Initial Deposit"). The Reserve Account is considered to be an asset of the Trust, which is maintained in the name of the Indenture Trustee[6], by the Administrator. The Administrator is [redacted]. The Reserve Account Initial Deposit is to be augmented on a regular periodic basis, from the funds remaining after the payment of obligations to the Note Holders and Certificate Holders and other expenses of the Trust. The amounts on deposit in the Reserve Account may likewise be released to [redacted] on a regular periodic basis, to the extent that the amounts on deposit therein exceed the "Specified Reserve Account Balance[7]." Any amounts remaining in the Reserve Account at the termination of the Trust will be released to the [redacted].

The amounts on deposit in the Reserve Account are available on each monthly or quarterly payment date to cover any shortfalls in payments due with respect to the Servicing Fee, Administration Fee, Note Holders' Interest Distribution Amount, Certificate Holders' Interest Distribution Amount, Note Holders' Distribution Amount or Certificate Holders' Distribution Amount. Payments of these items from the Reserve Account are to be made only to the extent funds collected on the student loans are not sufficient to make such payments. Amounts on deposit in the Reserve Account (other than amounts in excess of the Specified Reserve Account Balance, provided the Over Collateralization Amount is greater

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[5] The Sales and Servicing Agreement is an agreement between the Trustee, [redacted] (as seller of the student loans) and the Servicer of the student loans.

[6] The Indenture Trustee is [redacted].

[7] The Specified Reserve Account Balance is defined by a formula which is based, in part, upon the student loan amounts.

than the Specified Over Collateralization Amount[8]), will not be available to cover any unpaid Excess Servicing Fee, Note Holders' Interest Index Carryover or Certificate Holders' Interest Index Carryover.

The Reserve Account was established to provide a measure of security for the Trust and its investors, by providing an additional source of liquidity. It was recognized at the time that the Trust was established that at times, the amounts actually collected on the student loans for a particular collection period may not be equal to the repayments that are due. These differences could be caused by, among other things, defaults on the student loans or timing difference between the amounts due on the loans and the amounts then owed by the Trust. The Reserve Account was established to offset these differences. However, [redacted] has no obligation to supplement the Reserve Account Initial Deposit, and it is acknowledged in the Trust Prospectus that the Reserve Account could be depleted.

For tax purposes, [redacted] reported the sale of the student loans to the Trust net of the Reserve Account Initial Deposit. The examining engineer has determined that [redacted], as an accrual basis taxpayer, should have included Reserve Account Initial Deposit in income in the year of sale, i.e., [redacted], relying principally upon Hansen v. Commissioner, 360 U.S. 446 (1959). [redacted] disagrees, arguing essentially that Hansen does not apply, as [redacted] did not have a fixed right to the portion of the sales proceeds applied as the Reserve Account Initial Deposit in [redacted].

Analysis

Section 451 and the regulations thereunder provide the basic rules for determining when an item of income is includible in a taxpayer's gross income. For a taxpayer using an accrual method of accounting, income is includible when: 1) all the events have occurred which fix the right to receive the income and 2) the amount of the income can be determined with reasonable accuracy. Treas. Reg. Sec. 1.451-1(a). All the events that fix the right to receive income occur when: 1) the required performance occurs, 2) payment is due, or 3) payment is made, whichever happens earliest. Johnson v. Commissioner, 108 T.C. 448, 459 (1997). It is the time when the right to receive the income is fixed and not the actual receipt of the income that determines when the item should be included in income. Spring City Foundry Co. v. Commissioner, 292 U.S. 182, 184-185 (1934).

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[8] The Over Collateralization Amount and the Specified Over Collateralization Amount are also formulary amounts, based largely upon the student loan amounts.

In Commissioner v. Hansen, 360 U.S. 446 (1959), the U.S. Supreme Court addressed the question of whether accrual method taxpayers have a fixed right to receive income even though payment is withheld. The taxpayers were two automobile dealers and a trailer dealer who sold vehicles on an installment basis, receiving installment notes for the unpaid balance of the purchase price. The dealers would then sell the notes to finance companies. The finance companies paid over most of the purchase price to the dealers, e.g. 95%, and withheld the remainder, e.g., 5%, which the finance companies credited to reserve accounts in the dealers' names. The reserve accounts served as security for payment of the dealers' guarantees that they would repurchase the notes if the notes went into default. If the accumulated funds in the reserves exceeded a designated percentage of the unpaid principal balance of the various notes, the finance companies would pay the excess amount to the dealers.

The dealers argued, in part, that their right to the portion of the sales proceeds deposited to the reserves was not fixed, as it was not known, in the year of sale, how much of the reserve would actually be received by them in cash, and how much would be paid to the finance companies due to defaults on the installment loans. The Supreme Court rejected the dealers' argument, there was in fact no real contingency or uncertainty with respect to the deposits. The court reasoned that only one of two things could happen to the deposits - they would either be paid to the dealers or would be used to satisfy the dealers' guaranty obligations owing to the finance companies. No amounts could otherwise be charged against the reserve accounts by the finance companies which has not been authorized by the dealers. As the dealers effectively received the entire amount of the reserves in all events, the right to the receive the reserves was not conditional but absolute at the time they were withheld, and the dealers had to include the reserves in income at that time. Commissioner v. Hansen, 300 U.S. at 464-467. [redacted] argues that this same rationale does not apply, however, in the case of [redacted].

[redacted] argues that there is a real contingency or uncertainty in the case of [redacted], preventing it from satisfying the fixed right to receive requirement with respect to the portion of the sales proceeds applied as the Reserve Account Initial Deposit in [redacted]. [redacted] argues that [redacted], unlike the taxpayer in Hansen, is not a guarantor of the student loans and thus has no obligation to the Certificate Holders or Note Holders in the event of default on those loans. To the contrary, argues [redacted], the student loans were sold nonrecourse by [redacted] to the Trust. Furthermore, [redacted] argues, the Reserve Account was not established to pay any obligation of [redacted] nor does the creation of the Reserve Account create an inherent liability in [redacted]. [redacted] contends that [redacted] is not obligated to replenish the Reserve nor repay the Note Holders or Certificate Holders in the event the Reserve Account is depleted. [redacted] argues that the Reserve Account was established merely to enhance the likelihood of timely payments to the Note Holders and Certificate Holders.

[redacted] also argues that there is no "fixed right to receive" with respect to the Reserve Account Initial Deposit because it is uncertain what amount, if any, will ultimately be paid over to [redacted] from the Reserve Account. In particular, they point out that the funds remaining in the Reserve Account are to be released to [redacted] only if the amount on deposit exceeds Specified Reserve Account Balance - a moving target, to be determined at a future date. The factors determining the amount to be paid over to [redacted] are beyond its control. [redacted] points out that the student loans at issue were relatively new at the time of sale and as such, lacked a substantial repayment history. Without this history, argues [redacted], there was even greater uncertainty as to the disposition of the Reserve Account.

We believe that the case of General Gas Corporation v. Commissioner, 293 F.2d 35 (5th Cir. 1961), aff'g. 33 T.C. 303 (1959), provides substantial guidance regarding [redacted]'s claim that the Reserve Account is to be applied to items for which it has no obligation, i.e., [redacted] did not guarantee the loans, the loans were sold nonrecourse, the Reserve Account was not established to pay any other obligation of [redacted], the creation of the Reserve Account did not create an inherent liability in [redacted], [redacted] is not obligated to replenish the Reserve nor repay the Note Holders or Certificate Holders in the event the Reserve Account is depleted. In General Gas, the taxpayer was an accrual-basis dealer in household gas appliances, some which it sold on an installment credit basis. Customers who purchased the appliances on credit were required to execute a note in the amount of the unpaid portion of the selling price plus certain finance charges. The note was secured by a chattel mortgage or conditional sales contract. The taxpayer had sold these notes to finance companies without recourse. In exchange therefor, the finance companies paid the taxpayer an amount equal to the net cash selling price of the appliance less a fixed percentage. The withheld portion of the note sales price was set up as a reserve account on the finance company's books. The reserve was subject to specified charges against it for customer defaults, losses from repossession, interest charges and all other liabilities arising under the agreement with the financing companies. Payments by the finance company to the taxpayer were to be made only when the reserve exceeded 30% of the balance of all outstanding notes. On termination of the arrangement, the entire balance was to be remitted.

The General Gas opinion held, based on Hansen, that the taxpayer had a fixed right to receive the deposits to the reserve in the year of sale of the notes, regardless of whether the notes were sold with or without recourse, and that the amounts in the reserve were in fact available to pay liabilities of the taxpayer:

> We conclude that the Hansen case is in point and controlling as to the first issue raised by the Taxpayer. General Gas has attempted to distinguish the present situation on the facts by pointing out that the notes here involved were sold "without recourse," while those in Hansen were endorsed "with recourse." This distinction is not significant. While it is true that General Gas had no direct personal liability, the Reserve Account .... was liable for all customer defaults, losses from repossessions, payment of Bancredit's 7% interest charge and all other liabilities of General Gas under the financing contract. Consequently General Gas receives full financial benefit from the entire amount of these reserve credits. It receives in cash the cumulative reserve in excess of the 30% limit and, of course, will eventually receive the entire amount remaining to its credit. To the extent that charges are made against the reserve for note defaults and the like, they constitute offsets against, and hence payment of, liabilities of General Gas under the financing agreement. Therefore the entire amounts contained in the reserves will be received in full, either by reduction in liabilities or by cash payment. The fact that the financing agreements in effect put a ceiling on General Gas' economic liability did not alter in the slightest the full beneficial receipt of these sums by General Gas. Moreover, on the Hansen concept this was certain and known at the moment the credit was entered. Thus the language of Hansen, quoting from the Seventh Circuit, is equally applicable here. "Ultimately only two things could happen to the funds in the dealer's reserve accounts: either the amounts would be paid to the [dealer] in cash or they would be used to satisfy the [dealer's] other obligations to the finance companies." 360 U. S. 446 at 466, 79 S. Ct. 1270, 3 L. Ed. 2d 1360.

General Gas v. Commissioner, 293 F.2d at 38, 39. Clearly, General Gas rejects [redacted]'s position to the extent it relies upon the claim it had no obligation with respect to the loans because they were sold nonrecourse. Further, it makes no difference, according to General Gas, that [redacted] was not obligated to replenish the Reserve Account in the event it was depleted. Rather, as General Gas indicates, this merely represents a "ceiling" on the economic liability of [redacted], and does "...not alter in the slightest the full beneficial receipt of these sums.." by [redacted].

More importantly, however, the holding in General Gas was reached despite the fact that, as [redacted] argues here, the court found that the taxpayer lacked any direct personal liability (as guarantor or otherwise) to the purchaser due to default on the installment loans. Rather, the court looked to whether the taxpayer received a "financial benefit" from the reserve. The court found financial benefit to the taxpayer in the fact that the reserve "... was liable for all customer defaults, losses from repossessions, payment of Bancredit's 7% interest charge and all other liabilities of General Gas under the financing contract." The Reserve Account is to be drawn upon by the Trust when cash flow from the student loans, for whatever reason, is not sufficient to cover the Trust obligations to the Note Holders, Certificate Holders or its operating expenses. We find no meaningful difference between this purpose and that for which the reserves were available in either Hansen or General Gas. The practical problems and the solutions for all are essentially the same. The purchaser (in this case, the Trust) provides funds to the seller (here [redacted]) for its receivables, thus providing the seller with needed cash; the seller acquiesces to the reserve; the purchaser protects itself by it. The reserve therefore benefits the seller and he thus possesses the right to receive it within the context of income tax accrual accounting at the time the proceeds from the sale are deposited into the reserve. Bolling v. Commissioner, 357 F.2d 3, 6 (8th Cir. 1966).

Additionally, as the examining agent contends, [redacted] is benefitted by the Reserve Account Initial Deposit in that it enhanced the credit worthiness of the Trust to potential investors, and as such increased the marketability of the securities issued by the Trust. The proceeds of the security sales were what was used to purchase the student loans from [redacted]. Clearly, this represents a direct benefit to [redacted]. Stendig v. U.S., 843 F.2d 163, 166-167 (4th Cir. 1988).

Moreover, the Reserve Account in and of itself reflects an assumed liability of the [redacted], and financial benefit is realized by [redacted] to the extent the Reserve Account is applied to such liabilities:

> [The taxpayers] would distinguish Hansen on the ground that the present taxpayers, in contrast with the Hansen dealers who indorsed with recourse, have no personal liability to [the finance company] for losses incurred on the mortgages and that [the finance company] is relegated for its protection to the collateral share accounts. They note the emphasis in the Hansen opinion on resulting benefit to the dealers if the reserves are utilized to satisfy the dealers' obligations. If benefit is important, it is present here, too. The reserve in itself reflects an assumed, although limited, liability on the part of the taxpayer. When that liability is satisfied, benefit is realized. In any event, we view the distinction as one which occasions no different tax result; in either case, the reserve will come to the seller subject only to the normal credit risk of purchaser default. The purported distinction was noted and explicitly rejected in General Gas Corp. v. Commissioner, 293 F. 2d 35, 38-39 (5th Cir. 1961), cert. denied 369 U. S. 816.

(Emphasis supplied.) Bolling v. Commissioner, 357 F.2d at 7. We believe that Bolling directly refutes [redacted]'s argument that the Reserve Account creates no inherent obligation in [redacted].

[redacted] also attempts to rely on Wood v. U.S., 64-2 U.S.T.C. 9844 (N.D. Ala. 1964), although it acknowledges that this case was subsequently reversed in favor of the government. See U.S. v. Wood, 352 F.2d 522 (5th Cir. 1965). [redacted] argues that as was determined by the lower court with respect to the taxpayers in Wood, [redacted] likewise does not receive economic benefit from the Reserve Account as it owed no contractual obligation or guarantee with respect to the student loans. The appellate court in Wood found, however, that the taxpayer's deposit to the reserve was in fact made for the express purpose of providing additional security to the purchaser of the loans. However, as the facts herein demonstrate, the Reserve Account was established to provide liquidity to the Trust in the event it lacks liquidity which can arise due to among other things, defaults on the student loans. As such, we find that the facts of this case do not support application of the lower court's analysis in Wood. Furthermore, as Bolling indicates, the Reserve Account in and of itself represents the assumption of an obligation by [redacted] and payments therefrom are thus made in satisfaction of such obligation.

Finally, [redacted] attempts to challenge the inclusion of the Reserve Account Initial Deposit in its [redacted] income, alleging that its repayment is dependent upon factors beyond its control, such as the actions of the student loan borrowers. A similar challenge was raised and rejected in Bolling, the court ruling:

> For a reporting entity on the accrual basis the standard as to includability of an income item "is the right to receive and not the actual receipt. . . . When the right to receive an amount becomes fixed, the right accrues". Spring City Foundry Co. v. Commissioner, 292 U. S. 182, 184-85 (1934). The Court in that case made it clear that predicted uncollectibility, no matter how certain, does not affect a creditor's right to receive payment and, consequently, its obligation to accrue and include in gross income.

(Emphasis supplied.) Bolling v Commissioner, 357 F.2d at 5.

If you have any questions regarding the foregoing, please contact Chris Fisher at (216) 522-3380.

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